

REPORT OF THE
OFFICE OF THE AUDITOR GENERAL

REPORT ON
OPERATIONS OF THE
FRANCHISE TAX BOARD

JANUARY 1975

215.1

TO THE
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January 28, 1975

Honorable Bob Wilson
Chairman, and Members of the
Joint Legislative Audit Committee
Room 4126, State Capitol
Sacramento, California 95814

Dear Mr. Chairman and Members:

Transmitted herewith is our report on the operations of the Franchise Tax Board. The board itself is composed of the State Controller, the Director of Finance, and the Chairman of the State Board of Equalization. An executive officer, with overall administrative responsibility, is appointed by the board.

Our review of the board's audit-related activities has identified estimated income tax revenues lost to the state of \$60 million annually. In addition, we have identified one-time tax revenues owed to the state of \$51.6 million which, under the board's present procedures, will not be collected. The identified losses are due to the state under provisions of existing tax laws.

We estimate that 80 percent of the state's annual revenue loss is attributable to unreported income and overstated expenses of (1) non-California residents, (2) non-California corporations, (3) partnerships, and (4) persons who receive income, including dividends and interest, not subject to withholding taxes.

The Internal Revenue Service and various private firms provide the board with computer tapes and information returns identifying individuals who have received income which was not reported on their annual tax returns filed with the state. For example, 509,000 persons were so identified from computer tapes; in addition,

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an estimated 16,000 persons, who each received income in excess of \$10,000 not subject to withholding taxes, were so identifiable from information returns.

However, the board has not used this information to enforce the payment of taxes due. As a result, the state has lost tax revenues of an estimated \$11.1 million annually.

Further, these computer tapes and information returns identify individuals who have received income, and who owe taxes to the state, but who have not filed their annual tax returns with the state. For example, 288,578 persons were so identified from computer tapes; in addition, an estimated 40,000 persons, who each received income in excess of \$10,000 not subject to withholding taxes, were so identifiable from information returns.

However, the board has not used this information to require the filing of tax returns with the state and to enforce the payment of taxes due. As a result, the state has lost tax revenues of an estimated \$19.4 million annually.

In accordance with statutory requirements, approximately 130,000 partnerships annually file information returns with the board. These returns identify income, received by partners, which is not reported on a partner's individual annual tax return filed with the state. An estimated 21,000 partners were so identifiable from the partnership returns.

However, the board has not used this information to enforce the payment of taxes due. As a result, the state has lost tax revenues of an estimated \$3.6 million annually.

The board does not audit a sufficient number of tax returns in order to maximize the revenues paid to the state. For example, the board audited 368,341 fewer individual tax returns in 1973-74 than were audited in 1971-72, although the board expects its desk auditors assigned to individual returns to produce additional revenues of \$240,000 each in 1974. As another example, in 1973-74, each auditor assigned to major out-of-state corporate tax returns produced additional revenues of \$485,000, and yet the number of such returns audited by the board was only about 50 percent of the number necessary to achieve full audit coverage.

As a result of the board's insufficient audit coverage, the state loses tax revenues of an estimated \$25.9 million annually.

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During 1973-74, there were 245,000 individual delinquent tax accounts representing approximately \$100.2 million which the board has determined is owed to the state. Approximately 95 percent of these accounts have been delinquent for over two years and based on the board's present low staffing level, many of these accounts will never be collected.

While the number of uncollected accounts increased 20 percent between 1970-71 and 1973-74, staff time assigned to collection activities increased only three percent. The board's staff cannot adequately handle the increasing workload in a timely manner.

We estimate that the board's present rate of collection of delinquent income taxes from individuals will result in the failure to collect an estimated \$51.6 million in tax revenues owed to the state.

The board's executive officer has not made budget requests to obtain all needed positions. For example, for fiscal year 1974-75, he approved only 24 of the 71 positions requested by the board's Compliance Division, which is responsible for audit-related and collection activities.

We recommend that the computer tapes, information returns, and partnership returns provided to the board be used to require the filing of tax returns with the state and to enforce the payment of taxes owed to the state from identified individuals who have received income which was not reported on a state tax return. We further recommend that the board's audit coverage be substantially increased and that the board collect delinquent income taxes in a timely manner.

We estimate that the implementation of our recommendations will require an estimated 344 new permanent positions and 57 additional positions for a three-year period, and recommend that the board request such positions. In 1974-75, the board has an authorized staff of 2,262 positions.

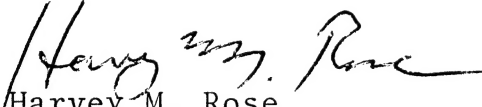
While the annual cost of the 344 positions and related expenses would be approximately \$6.6 million and the three-year cost of the 57 positions would be approximately \$1.9 million, we estimate

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that such costs would produce additional tax revenues of an estimated \$60 million annually, and will prevent a one-time tax revenue loss to the state of an estimated \$51.6 million.

Respectfully submitted,


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INTRODUCTION

In response to a legislative request, we have reviewed the operations of the Franchise Tax Board. The primary purpose of this review was to evaluate the effectiveness of the board in meeting its objective, as stated in the 1974-75 Governor's Budget, "to administer the Personal Income Tax Law and the Bank and Corporation Tax Law in a manner which will assure equity for the taxpayer and maximize the state's revenue potential within the framework of these laws".

The board is organized in the state government as a part of the Agriculture and Services Agency.

The membership of the board consists of the State Controller, the Director of Finance, and the Chairman of the State Board of Equalization. The administrative responsibilities of the board have been delegated to their appointed Executive Officer. The board retains the policy functions of setting the tax rate on banks and financial corporations and adopting rules and regulations. Tax rates for individuals and other types of corporations are established by the Legislature.

The main offices of the board are located in and near Sacramento. Regional offices in Los Angeles and San Francisco exercise administrative control over 13 branch offices located in various cities throughout the state. Out-of-state offices are maintained in New York City and Chicago.

The regional and branch offices perform the field auditing of taxpayers' records, assist in tax collections, and provide information service to the taxpayers of the state. The out-of-state offices perform audits of out-of-state corporations doing business in California, but whose records are kept in other states.

The board administers the following three laws:

- Individual Income Tax Law, which includes individuals and partnerships
- Bank and Corporation Tax Law
- Senior Citizens Property Tax Assistance Law.

The concepts of self-assessment and voluntary payment by taxpayers are fundamental to the successful execution of the board's programs. Every effort is directed to promoting those concepts.

For fiscal year 1973-74, the board received approximately \$2,889,557,000 of tax revenues or 46 percent of the total revenue received to support the state's General Fund program, as follows:

Individual Income Taxes	\$1,832,349,000
Bank and Corporation Taxes	<u>1,057,208,000</u>
Total	<u>\$2,889,557,000</u>

Such revenues, which were received from approximately 7.8 million individual taxpayers and 238,000 banks and corporations, were the largest amount of annual revenues received in the board's history. Most of these revenues directly resulted from withholding of taxes on wages paid and from voluntary payment on the taxpayers' part. Only approximately \$135 million resulted from the board's audit-related activities.

The scope of our review concentrated on the audit, enforcement and collection activities of the board.

Audits of tax returns, which include adjustments based on information provided by the Internal Revenue Service, are conducted to determine if the correct amount of tax was reported on filed tax returns.

Enforcement activities are performed to enforce the filing of tax returns by all individuals who are required to file but who have not filed such returns.

Collection activities are performed to collect delinquent income taxes from individuals, banks, and corporations.

The scope of our review included an examination of a total of 2,035 individual, partnership and corporate tax returns for the most recent periods available. We did not examine any documentation maintained by taxpayers to support these returns.

While in fiscal year 1973-74 the Franchise Tax Board assessed taxpayers approximately \$135 million from audit-related activities, our

review of the board's operations has identified estimated audit-related income tax revenues lost to the state of \$60 million annually, or approximately 44 percent of the \$135 million assessed in fiscal year 1973-74.

In addition, we identified one-time income tax revenues owed to the state of \$51.6 million which, under the board's present procedures, will not be collected. The identified losses are due to the state under provisions of existing tax laws and are based on current board procedures.

We estimate that 80 percent of the audit-related revenues lost to the state are revenues not collected from (1) non-California residents who derive income in the State of California, (2) corporations incorporated in another state but doing business in California, (3) individuals who derive income from partnerships, and (4) individuals who derive income not subject to withholding taxes such as dividends, interest, rents, commissions and other non-wage type income.

State withholding taxes on wages paid to individuals was instituted in 1972. The estimated savings relating to individual income taxes contained in this report are based on data subsequent to the institution of this withholding plan.

The Franchise Tax Board cooperated fully with us during the course of our audit.

In presenting this report, it was necessary to disclose certain policies established by the Franchise Tax Board which determine parameters of audit. Such policies change from year to year and are currently under review by the Board.

FINDINGS

THE FRANCHISE TAX BOARD DOES NOT MAKE
OPTIMUM USE OF AVAILABLE TAX INFORMATION
AND DOES NOT AUDIT A SUFFICIENT NUMBER OF
TAX RETURNS. AS A RESULT, THE STATE LOSES
TAX REVENUES OF AN ESTIMATED \$60 MILLION
ANNUALLY.

The Franchise Tax Board does not make optimum use of available income information from computer tapes, miscellaneous information returns, and partnership information returns to ensure that the maximum amount of tax revenues, due from individuals, banks and corporations, under existing tax laws, are paid to the state. Further, the board does not audit a sufficient number of tax returns to ensure that the state is paid the maximum amount of tax revenues due.

As a result, the state loses tax revenues of an estimated \$60 million annually.

The Franchise Tax Board Does Not Make Optimum
Use of Available Information to Adjust the
Taxes Due from Identified Individuals Who
Have Filed State Tax Returns.

Income Information Available From Computer Tapes

The Franchise Tax Board receives computer tapes containing individual income information from the Internal Revenue Service (IRS), the State Employment Development Department (EDD) and various private firms, including banks and savings and loan associations.

These tapes identify individuals as having received various income subject to withholding taxes, such as wages, as well as income not subject to withholding, including dividends, interest, rents, commissions, and other non-wage type income.

The board mechanically compares the externally provided tapes with its own tapes which contain similar information for those individuals who have filed state tax returns. The primary purpose of this comparison is to identify individuals who have not filed state tax returns, as discussed on page 8.

However, on the basis of this tape comparison, another listing is also prepared which identifies individuals who, in their tax returns filed with the state, have either understated or who have not reported at all various amounts of income received by the individuals.

For example, in the 1972 tax year, approximately 509,000 persons who filed state individual tax returns were identified as having received income which was understated or not reported at all on their tax returns filed with the state. However, the board did not use this available information to adjust the taxes due from the various individuals.

We examined a statistical sample of filed 1972 state tax returns of the 509,000 individuals identified from the computer tapes. While we found various tabulating and programming errors on the tapes which accounted for a significant portion of the reported discrepancies, income on 25 percent of the examined tax returns was either understated or not reported at all.

Based on our examination, we estimate that additional tax revenues of at least \$6.7 million annually should be paid to the state.

Income Information Available from Information Returns

Approximately seven million miscellaneous income information returns (Franchise Tax Board Form 599), in lieu of computer tapes, are filed annually with the board by various private firms. Such returns report payments to individual taxpayers of dividends, interest, rents, commissions, and other non-wage type income which is not subject to withholding taxes.

For the 1972 and 1973 tax years, the board destroyed these information returns soon after the annual filing period. These returns were not used by the board to assure that individuals reported the income, contained in the information returns, on their individual tax returns.

Accordingly, the board made no tax adjustments, for taxes due, on the basis of these information returns.

Although these information returns were destroyed soon after the filing period, we were able to obtain and review a limited sample of returns for the 1973 tax year which were salvaged for us prior to their destruction. The returns we examined included only those which reported income payments to individuals in excess of \$10,000.

Six percent of the individuals included in our sample who filed state tax returns for the 1973 tax year received income, not subject to withholding taxes, which was either understated or not reported at all on their tax returns filed with the state. We estimate that at least 16,000 individuals who each received income in excess of \$10,000 in 1973 either understated such income or did not report it at all for the 1973 tax year.

Based on our sample, we estimate that additional tax revenues of \$4.4 million annually should be paid to the state.

The Franchise Tax Board Does Not Make Optimum
Use of Available Information To Require the Filing
Of State Tax Returns by Identified Individuals Who
Have Failed To Do So But Who Owe Taxes To the State.

Income Information Available from Computer Tapes

As previously mentioned, computer tapes identifying individuals who receive income, including income not subject to withholding taxes, are received by the Franchise Tax Board from IRS, EDD, and various private firms. These externally provided tapes are mechanically compared to the board's own computer tapes containing income information of individuals who have filed state tax returns.

This mechanical comparison of board tapes with the externally provided tapes resulted in the identification of 288,578 individuals who did not file tax returns for the 1972 tax year, and who, according to the board estimates, owe taxes of \$10 to \$100 each.

However, the board does not use this information to require these individuals to file tax returns since it is the board's practice that, if the estimated net tax due is \$100 or less, the individuals are not issued a notice to file a tax return.

The board's practice to relax filing requirements on individuals with an estimated tax liability of up to \$100 is completely inconsistent with the board's policy relating to underpayments of tax by individuals who have filed tax returns. In the latter case, the board bills taxpayers for any taxes due, amounting to one dollar or more, which were not paid when the return was initially filed. Further, as a result of audit adjustments made by the board, the board bills individual taxpayers for additional assessed taxes of \$5 or more.

The board's practice of not requiring individuals to file tax returns, when the estimated taxes for such individuals are up to \$100, applies generally to individuals with income of \$9,000 or less. Yet statistical reports compiled for the 1972 tax year, the latest available, show that over 3.4 million returns were voluntarily filed with income of \$9,000 or less. Such returns represented over 49 percent of all individual income tax returns filed that year and accounted for over \$78 million in tax revenues.

Based on the computer tape computations of the estimated tax liability for the 288,578 non-filers in the 1972 tax year, we estimate that additional tax revenues of \$8.7 million annually should be assessed. The Franchise Tax Board estimates that many of the non-filers might actually be entitled to a refund if they filed a return. However, based on the board's prior refund experience, we estimate that of the \$8.7 million assessments, additional net tax revenues of \$2.6 million annually should be paid to the state.

Income Information Available from Information Returns

As previously mentioned, information returns (Franchise Tax Board Form 599), containing income data not subject to withholding taxes, are provided to the board by various private firms. Such income is received by the individuals identified on the forms. As previously noted, these returns were destroyed by the board and consequently were not used by the board to assure that individuals required to file tax returns did so.

We sampled the information returns for the 1973 tax year for only those individuals who were paid in excess of \$10,000 in income not subject to withholding taxes.

Approximately 14 percent of the individuals included in our sample had not filed tax returns with the state in 1973, despite the documented fact that such individuals received in excess of \$10,000 in income not subject to withholding taxes. Based on our sample, we estimate that at least 40,000 individuals, each received income in excess of \$10,000 in 1973 on which they owe taxes to the state. These individuals should have filed tax returns with the state for the 1973 tax year, but were not required to do so by the board.

Based on our sample, we estimate that additional tax revenues of \$16.8 million annually should be paid to the state.

It should be noted that for the 1971 tax year, the latest year for which the board did make use of the income information reported on the information returns, the board billed approximately 81,000 individuals, who had not filed tax returns with the state, an estimated \$18.8 million for taxes, penalties and interest.

The Franchise Tax Board Does Not Use The
Information Contained in Partnership Returns
Filed with the State To Adjust the Taxes Due
For Partnership Income Which Should Have Been
Reported on the Partners' Individual Tax Returns.

In accordance with statutory requirements, approximately 130,000 partnerships annually file information returns with the state. Such returns identify the partners' names and addresses, the amounts of income and deductions allocated to each partner, and the net profit resulting from operations. While the partnerships themselves do not pay state income tax, the law requires that each of the partners report his distributive share of partnership income on his individual return for the purpose of computing individual taxable income.

The board did not compare these partnership returns filed with the state with the partners' individual returns to determine if the partnership income is reported on individual income tax returns. Accordingly, the board made no tax adjustments, for taxes due on individual returns, on the basis of unreported partnership income.

Based on a sample from 45,600 partnership returns for the 1972 tax year, consisting of approximately 136,800 individual partners, we estimate that 21,000 partners received partnership income which was understated or not reported at all on the partners' individual tax returns.

Based on our examination, we estimate that additional tax revenues of at least \$3.6 million annually should be paid to the state.

The Franchise Tax Board Does Not
Audit A Sufficient Number of Tax Returns

There are three types of tax return examinations for which the Franchise Tax Board does not audit a sufficient number of tax returns in order to maximize the revenues paid to the state:

- Field audits of out-of-state corporations
- Desk audits of individual income tax returns
- Field audits of individual income tax returns.

Such audits have resulted in the determination of both unreported income and overstated expenses.

In recent years, there has been an increase in the state's economic growth, an increase in the number of tax returns filed with the board, and there have been tax rate increases. All of these items have contributed to an increased workload for the board's auditing staff. However, except for five additional auditing positions requested and approved for the 1973-74 budget, there have been no other staff increases for auditing positions since 1971-72. Responsibility for budget requests is explained on page 26.

While in fiscal year 1973-74 the board made field and desk audits of 599,056 individual tax returns, this represents a decline of 368,341 tax returns from 1971-72 when such detailed audits totaled 967,397.

One reason for this decline is the increased emphasis on taxpayer information assistance, which we recognize is a necessary function. Another reason for the decline is the shift of personnel to other audit areas including

audits of information provided by the Internal Revenue Service. While field audits of out-of-state corporate tax returns increased by 1,976 from fiscal year 1971-72 to 1973-74, this increase still does not provide sufficient audit coverage as explained below.

We note that in a memorandum dated July 26, 1973, the Chief of the board's Compliance Division, which is responsible for audit-related and collection activities, recognized the decline in audit activities and stated:

"What has occurred has been a gradual erosion of the Audit and Collection function. Since the 'Service' function must be met the Administrators had no choice but to draw out of the Audit and Collection staffs to meet the problem. This is not an economical use of these professional people."

It is recognized that the board attempts to concentrate its audit efforts on those tax returns having the highest audit potential, while at the same time maintaining a reasonably balanced audit program.

Field Audits Of
Out-of-State Corporations

The most productive field audit program conducted by the board is the examination of tax returns of major out-of-state based corporations that do business in California. This field audit program generated \$31.5 million in additional taxes, interest and penalties during 1973-74. Since 1968-69 over \$111 million has been realized from this audit program. The corporate tax returns now audited are the largest, as well as those determined to have the most audit potential.

However, even with this high degree of success, a significant amount of additional tax revenues is never realized due to the board's limited audit coverage. In 1973-74, the current audit staff of approximately 65 auditors, working out of Chicago, New York City and California, audited 7,636 tax returns of major out-of-state corporations. This represents only about 50 percent of the estimated 15,200 major corporate tax returns which should be audited annually to obtain full audit coverage.

For tax return audits of out-of-state corporations in 1973-74, the state realized about \$17.50 for each dollar of state cost incurred. On the average, the audit of each out-of-state corporate tax return produced \$4,126 of additional tax revenues in fiscal year 1973-74.

Based on the 1973-74 experience of \$4,126 of tax revenues produced per audit of each major out-of-state corporate tax return, an estimated \$31.5 million in additional tax revenues would have been paid to the state if the remaining approximately 7,600 major corporate tax returns, which were not audited, had been audited.

Although there is no precise measurement available to determine the potential additional tax revenues from the corporations not now audited, we conservatively estimate that the increase in tax revenues from such additional audits would be 50 percent of the tax revenues realized from the 1973-74 audits of major out-of-state corporate tax returns. On that basis, an estimated \$15.7 million annually of additional tax revenues should be paid to the state.

Desk Audits Of
Individual Tax Returns

Desk audits consist of a quick review by trained auditors and technicians of individual tax returns for unusual or specified items. The full potential of a desk audit review of individual tax returns has never been realized. A computer-generated file is used to identify those tax returns which have audit potential. However, not all such identified returns are audited.

For example, during 1974, the auditors assigned to this function are to review approximately 16 percent, or 243,000 tax returns having the highest audit potential, of the 1,511,035 individual tax returns identified by the board in the computer file as having audit potential. The additional net tax revenues expected by the board to be generated from such current desk audit review in 1974 is about \$3.1 million, or \$240,000 per auditor. However, the remaining 1,268,035 individual tax returns are not audited.

The procedures for desk audits of individual income tax returns were changed during fiscal year 1973-74. Prior to that time, a greater number of tax returns were audited because a taxpayer's three most recent returns were audited as a unit, and necessary adjustments were made to any or all tax years as required. Present procedures provide for auditing only the most recent year's return of a taxpayer. In addition, audit effort for this program was reduced from about 16.5 audit man-years to less than ten audit man-years. This does not include time spent by trained technicians who review the propriety of various specified items on the returns, but who do not actually audit the entire return.

As a result of these changes, fewer returns are being audited and the board has projected that less additional tax will be assessed based on these audits. In fact, in its report on 1973-74 activities the board states: referring to this change in procedure:

"The tax change through audit decreased \$6.6 million [mainly in tax assessments] and the cost decreased \$.2 million mainly due to the elimination of drawer audits and the implementation of an automated audit selection program which operated on a limited basis from January through June."

Based on the board's actual prior audit results, we estimate that desk audits of all 1,511,035 individual tax returns, identified by the board as having audit potential, would result in total revenues of \$10.9 million annually or \$7.8 million annually in excess of the board's 1974 expectations of additional tax revenues being paid to the state. This would increase the number of annual desk audits by approximately 1.2 million.

Field Audits Of
Individual Tax Returns

Field audits require site investigations at the individual taxpayers' residence or business. The number of individual tax returns identified by the board as having field audit potential increased 36 percent from 227,000 in 1971-72 to 308,000 in 1973-74. During this same period the number of such tax returns actually subjected to field audits decreased 15 percent, from 13,032 to 11,056, and there was a decrease in additional tax assessed from approximately \$7.4 million to \$4.4 million.

In order to maintain the same level of field audit effort as existed in 1971-72, an estimated 6,700 of the individual tax returns identified by the board as having audit potential should have been subjected to field audit in 1973-74, in addition to the 11,056 returns which were audited by the board. Based on the board's actual prior audit results, these 6,700 audits would have resulted in payments to the state of additional estimated tax revenues of \$2.4 million for fiscal year 1973-74.

CONCLUSION

The optimum use of available tax information and the auditing of a sufficient number of tax returns is essential if the Franchise Tax Board is to meet its stated objective of administering "the Personal Income Tax Law and the Bank and Corporations Tax Law in a manner which will assure equity for the taxpayer and maximize the state's revenue potential within the framework of these laws."

RECOMMENDATIONS

We recommend that the Franchise Tax Board:

- Adjust the taxes due from identified individuals who have filed state tax returns and who have received income, including income not subject to withholding taxes, which was understated or not reported at all on their individual tax returns filed with the state. Such individuals are identified from computer tapes

and information returns presently provided to the board by the Internal Revenue Service (IRS), the State Employment Development Department (EDD) and various private firms.

- Require identified non-filing individuals to file tax returns with the state when such individuals have received various income, including income not subject to withholding taxes, and owe taxes to the state. Such non-filers are identified from computer tapes and information returns presently provided to the board by IRS, EDD and various private firms.
- Adjust the taxes due from individuals for their partnership income which should have been reported on the partners' individual tax returns filed with the state.
- Increase annual audit coverage by approximately 7,600 field audits of major out-of-state corporate tax returns, 1.2 million desk audits of individual tax returns consisting of a quick review for unusual items, and 6,700 field audits of individual tax returns.

SAVINGS AND BENEFITS

Implementation of these recommendations will result in an estimated \$60 million annually of additional tax revenues being paid to the state, and will increase equity for all taxpayers under provisions of existing tax laws.

UNTIMELY COLLECTION PROCEDURES BY THE FRANCHISE TAX
BOARD FOR DELINQUENT INDIVIDUAL INCOME TAXES OWED TO
THE STATE WILL RESULT IN A ONE-TIME REVENUE LOSS TO
THE STATE OF AN ESTIMATED \$51.6 MILLION.

The board's initial efforts to collect delinquent income taxes due from individuals consist of computer billings. Individual accounts are declared delinquent and the computer billings occur if taxes, due to the state on a certain filing date or due on a subsequent date as a result of board audits, remain unpaid. Most past due accounts are settled as a result of these initial computer billings. However, many individuals fail to respond and further collection efforts are required. In this regard, the board's collection procedures pertaining to delinquent income taxes have been untimely.

The board's overall collection workload has decreased since the institution in 1972 of state withholding taxes on wages paid to individuals. However, the board's workload, for the collection of delinquent taxes which have still not been paid subsequent to the board's initial computer billings, continues to increase.

The board's average monthly ending balance for 1973-74 contained 245,100 individual income tax accounts, which were delinquent beyond the initial billing stages, representing approximately \$100.2 million in unpaid taxes, interest and penalties which the board has determined is owed to the state.

Approximately 95 percent of these accounts have been delinquent for over two years. Based on the board's present staffing level regarding collection efforts for delinquent taxes, many of these accounts will never be collected.

The number and dollar amount of uncollected accounts, which have increased 20 percent and 96 percent respectively between 1970-71 and 1973-74, have been increasing annually. This has occurred even though withholding of taxes on wages earned was instituted by the state in 1972.

While the staff assigned to the work involving the collection of the delinquent accounts has increased by 15 percent to 76 collection representatives during the same period, such employees cannot adequately handle the rapidly increasing workload in a timely manner. Further, an estimated 43 percent of staff time is expended on non-collection activities, such as taxpayer information assistance, thereby reducing the time available for collection efforts. When adjusted for the increase in non-collection activities, the equivalent number of collection representatives assigned to collection activities actually increased by only two positions, or 3 percent, between 1970-71 and 1973-74, as compared to the increased workload of 20 percent.

District Offices

Following the initial computer billings, delinquent accounts are generally assigned by the board to its district offices for followup collection action by 60 collection representatives.

The board's average monthly ending balance at the district offices for 1973-74 contained 66,300 accounts totaling approximately \$44 million owed to the state. Therefore, each collection representative had an average in-process caseload of 1,100 accounts. While this caseload has not significantly increased since 1970-71, collection representatives stated that the maximum in-process caseload which can be handled in a timely, and therefore effective

manner, is 500 accounts. Our analysis of the collection activities for the delinquent accounts at the district offices disclosed that the heavy caseload on the district collection representatives has prevented them from taking timely action to collect the amounts due to the state.

If the accounts are declared to be uncollectible by the board's district offices, they are transferred to either the headquarters' Special Procedures unit for specialized collection procedures, or to a headquarters processing program called "Limbo".

Special Procedures

Delinquent accounts transferred to the Special Procedures unit from district offices are assigned to 16 collection representatives. Because of the circumstances of the delinquent taxpayers, these accounts require specialized collection procedures, knowledge of law and legal proceedings, or coordination with the State Attorney General. Examples of these circumstances include bankruptcy, probate of estates, out-of-state residency, or imprisonment.

The board's average monthly ending balance for 1973-74 contained approximately 45,800 accounts totaling approximately \$23.7 million owed to the state. Such accounts were on hand for special collection procedures. This represents an increase of 103 percent in the number of accounts and 169 percent in amounts owed since 1970-71. During this same period the number of authorized collection representatives increased from 12 to 16, or only 33 percent.

In 1973-74, the average in-process caseload was 2,800 accounts per collection representative. Collection representatives stated that the maximum in-process caseload which can be handled in a timely manner is 400. Our analysis verified that these accounts are not being collected in a timely manner.

In addition to the specialized nature of these accounts, the accounts assigned to this unit for collection are generally more difficult to collect than those assigned to district offices, since they are older than those still assigned to the districts. Also, for approximately 75 percent of these delinquent accounts, available documentation concerning the problems relating to the delinquencies is limited and in some instances has been discarded.

Limbo

Delinquent accounts, not requiring specialized collection procedures, are transferred from the district offices to Limbo after the district office collection representatives determine them to be uncollectible or after it is determined that the cost to collect them would be excessive. After assignment to Limbo status, collection followup consists of a computer-generated quarterly billing to the delinquent taxpayer.

The board's average monthly ending balance for 1973-74 contained approximately 133,000 delinquent accounts assigned to Limbo, totaling more than \$32.5 million owed to the state. This is an increase of 89 percent in the number of accounts and 271 percent in amounts owed compared to 1970-71.

No permanent collection staff is assigned to periodically review and to inquire as to the status of the Limbo accounts, although many of these accounts have been updated with new information subsequent to the transfer of these accounts from the district offices to Limbo. For example, during 1974, over 68,000 Limbo accounts were updated with newer address information received from the Internal Revenue Service. While the quarterly computer billings to the

delinquent taxpayers continued, the board's collection staff made no further inquiries regarding these accounts.

On occasion, the board has initiated programs for its collection staff to make further inquiries regarding some of the Limbo accounts. Generally, these programs have been successful, but all were discontinued before their full potential was realized. The most recent such effort on Limbo accounts occurred in 1973 when a small work force of temporary collection personnel selectively evaluated about eight percent of the Limbo files. As a result of this effort, over \$548,000 was collected at a salary cost of \$35,000. This program was discontinued because of budgetary restrictions even though the board was realizing about \$16 in revenue for each dollar of payroll expenditure.

Our tests show that about 26 percent, or \$8.4 million, of delinquent accounts assigned to Limbo would be collectible by making further inquiries based on updated information in lieu of sending computer billings, on a quarterly basis, to taxpayers.

Summary - Collection Of
Delinquent Individual Income Taxes

There has been a significant increase in the number and in the amount of delinquent income tax accounts between 1970-71 and 1973-74 without a corresponding increase in staff. Collection representatives at the district offices and in the Special Procedures unit are continuously responsible for a caseload of 600 and 2,400, respectively, of delinquent accounts in excess

of what they can handle in a timely manner. No permanent staff is assigned to make periodic inquiries of the Limbo accounts. Therefore, the collection of individual delinquent income tax accounts cannot be made in a timely manner, particularly as the delinquent accounts become older.

As previously noted, approximately 95 percent of the accounts which are delinquent beyond the initial computer billing stages contain monies owed to the state for over two years. The board's actual prior experience in the collection of these individual delinquent income tax accounts is to recover approximately 51.5 percent of the amounts the board has determined are owed to the state. Based on this prior experience, and based on the board's increasing workload without a corresponding increase in staff, we estimate that without sufficient staff increases to make collections in a timely manner, a one-time loss to the state of \$51.6 million in tax revenues, including interest and penalty income, will result.

CONCLUSION

The board's present rate of collection of delinquent income taxes from individuals will result in the non-collection of substantial revenues owed to the state.

RECOMMENDATION

We recommend that the Franchise Tax Board collect delinquent income taxes from individuals in a timely manner. This recommendation will require additional board staff as explained on pages 26 through 28.

SAVINGS

Implementation of this recommendation will prevent an estimated one-time revenue loss to the state of \$51.6 million.

THE FRANCHISE TAX BOARD HAS NOT MADE BUDGET
REQUESTS TO OBTAIN ALL NEEDED POSITIONS.

The Franchise Tax Board has not submitted budget requests to obtain all needed positions for the purpose of making optimum use of available tax information, for the purpose of auditing a sufficient number of tax returns, and for the purpose of the collection of delinquent income taxes in a timely manner.

For example, a recap of the board's budgeted number of new positions requested for audit-related and collection activities and the total authorized number of such positions for fiscal years 1973-74 and 1974-75 is as follows:

<u>Fiscal Year</u>	<u>New Positions Requested</u>			<u>Total Authorized Number of Positions</u>
	<u>Number Requested By Compliance Division</u>	<u>Number In Turn Requested By Executive Officer</u>	<u>Number In Turn Requested by Agriculture and Services Agency*</u>	
1973-74	44	36	36	812
1974-75	71	24	6	818

These positions exclude additional positions requested for taxpayer assistance which may have been used to replace auditors who were performing taxpayer assistance functions.

*Also approved by the Governor and the Legislature.

Therefore, as can be seen above, the Executive Officer reduced the Compliance Division's budget requests by 8 positions and 47 positions in fiscal years 1973-74 and 1974-75 respectively. In turn, the Agriculture and Services Agency reduced the Executive Officer's requests by 0 positions and 18 positions in fiscal years 1973-74 and 1974-75 respectively.

In connection with the 1974-75 budget, the Chief of the board's Compliance Division stated, "It is time that it be recognized and taken as a fact that the department can and does know how to use its Audit staff effectively and that substantial tax change will result from the application of additional Audit effort."

As one example of the direct dollar benefits of auditing positions, in fiscal year 1973-74, each auditor working on audits of major out-of-state corporate tax returns produced approximately \$485,000 in net additional tax revenues to the state.

For fiscal year 1974-75, the Franchise Tax Board is authorized 2,262 positions for its entire operation, including the 818 audit-related and collection positions.

Based on the present board staffing pattern, we estimate that the implementation of the recommendations contained on pages 17, 18 and 24 would require additional auditing, clerical, collection, computer and legal positions as follows:

- 344 new permanent positions, needed for making optimum use of available tax information and for increasing audit coverage, at an estimated annual cost of \$6.6 million, including personnel and related costs. We estimate that such costs would produce additional tax revenues of \$60 million annually or net additional revenues of \$53.4 million annually.

- 57 additional positions for a three-year period needed for the collection of delinquent individual income tax revenues, at a one-time estimated cost of \$1.9 million over the three-year period, including personnel and related costs. We estimate that such one-time costs would prevent a one-time tax revenue loss to the state of \$51.6 million, or a net one-time revenue loss of \$49.7 million.

CONCLUSION

The employment of additional personnel by the Franchise Tax Board will produce substantial additional tax revenues for the state, and will prevent a one-time tax revenue loss to the state.

RECOMMENDATION

We recommend that the Franchise Tax Board request 344 new permanent positions and an additional 57 positions for a three-year period.

NET SAVINGS

Implementation of this recommendation, in conjunction with the recommendations on pages 17, 18 and 24, will result in an estimated \$53.4 million annually of net additional revenues being paid to the state, and in an estimated \$49.7 million of net additional one-time revenues being paid to the state over a three-year period.

SUMMARY OF COMMENTS
OF THE EXECUTIVE OFFICER
OF THE FRANCHISE TAX BOARD
AND HIS STAFF

1. Initially, we cannot comment on the accuracy of the figures contained in the report. We will, however, take a hard look at the Auditor General's report and will review the Auditor General's work papers.
2. The most important point to remember is that the present income tax system is a system built upon the concepts of self-assessment and voluntary payment. Implicit in any such system is the fact that there is always money due which is not collected. The question is whether the economics justify collection.
3. Most of the recommendations of the Auditor General will require additional staff. The budgetary climate has not been suitable to asking for large requests in personnel. In fact, at times the Board has been directed not to add any positions in its budget requests. Further, before positions can be added, they must be justified by hard economic data. Even when justified, there are practical problems in recruitment and training. Further, certain programs, such as the collection program, are currently being reevaluated and the addition of staff prior to the completion of this reevaluation would be premature.
4. In addition to the problem of a lack of staff, it should be remembered that the work of the Franchise Tax Board has to be viewed as a whole and that certain functions of the Board have a higher priority than others, such as the imposition of withholding in 1972 which caused considerable

organizational problems in its implementation, and the heavy increase in workload of the Board resulting from the increase in taxpayer information services since 1971.

5. Based on the Auditor General's suggestion of several months ago, the Franchise Tax Board has started to compare income from partnership returns to individual returns filed by the partners with the state.
6. It should be pointed out that every second year we have added some additional staff to audit major out-of-state corporate tax returns. Again, we have to move slowly in these areas because new staff requires additional training and therefore we cannot add a large number of staff at one time. Another problem with auditing major out-of-state corporate tax returns is that salaries do not compare favorably with prevailing rates in both Chicago and New York which causes recruiting problems.